

VZCZCXRO4430  
OO RUEHDBU RUEHFL RUEHKW RUEHLA RUEHROV RUEHSR  
DE RUEHMO #1765/01 2921300  
ZNY CCCCC ZZH  
O 191300Z OCT 06  
FM AMEMBASSY MOSCOW  
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4225  
INFO RUEHRC/DEPT OF AGRICULTURE WASHDC IMMEDIATE  
RUCPDO/DEPT OF COMMERCE WASHDC IMMEDIATE  
RHEBAA/DEPT OF ENERGY WASHDC IMMEDIATE  
RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE  
RHEHNSC/NSC WASHDC IMMEDIATE  
RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY  
RUCNCIS/CIS COLLECTIVE

C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 011765

SIPDIS

SIPDIS

LONDON FOR VISITING USTR DEL FOR DWOSKIN  
STATE PASS USTR FOR DONNELLY  
STATE FOR EUR/RUS WARLICK AND HOLMAN  
STATE FOR FOR EB/ESC/IEC GALLOGLY AND GARVERICK  
DOE FOR HARBERT/EKIMOFF/PISCITELLI  
DOC FOR 4231/IEP/EUR/JBROUGHER  
NSC FOR GRAHAM AND MCKIBBEN  
USDA FOR OSEC/TERPSTRA  
USDA FAS FOR ITP/MACKE, FLEMINGS, THOMAS; DLP/WETZEL

E.O. 12958: DECL: 10/20/2016

TAGS: [ECON](#) [ENRG](#) [ETRD](#) [KIPR](#)

SUBJECT: OCT 18 MEETING WITH KREMLIN ECONOMIST DVORKOVICH

Classified By: Ambassador William J. Burns by reasons 1.4 (b) and (d).

11. (C) SUMMARY. In a wide ranging discussion with Economic Minister-Counselor October 18, Arkadiy Dvorkovich, Head of the Experts Group of the Russian Presidential Administration exuded quiet confidence about the difficult path of economic reform in Russia. He cited recent positive movement across a diverse array of issues, including electricity, gas, municipal government and tax reform, predicting as well that long-stalled legislation on foreign investment in strategic sectors (including energy) could move into the Duma before the end of the year. Expressing concern about the killing of Central Bank Deputy Andrey Kozlov, Dvorkovich predicted Kozlov's reforms would continue. On WTO, Economic Minister-Counselor raised USG dismay over indefensible Russian Veterinary Service claims of substandard U.S. meat handling and the deeply flawed Part IV of the Civil Code on IPR. Dvorkovich expressed understanding for the situation Russian Veterinary inspectors were creating regarding USG sanitary and phytosanitary norms for beef and pork, and promised to raise our concerns about the flawed approach to IPR protection contained Part IV of the Civil Code in Kremlin circles. Responding to questions about contract sanctity for U.S. oil companies, Dvorkovich claimed no broad attack on Production Sharing Agreements was in play, but that Sakhalin II operators were seen as badly abusing their privileged position and would need to come to a reasonable negotiated outcome with the GOR on the cost overrun issue. He said there were no plans to replace former Presidential Economic Advisor Andrey Illarionov and that Illarionov's staff had been disbanded. END SUMMARY.

12. (C) Atmospherics. Unlike previous encounters over the past two years, Dvorkovich was visibly less haggard and displayed much of his hallmark enthusiasm. In contrast to his downbeat assessment of the outlook for reform a year ago (in the wake of the problems which plagued the monetization of benefits in early 2005) he noted a wide range of positive developments in motion on everything from taxes to electricity to federal-municipal relations. He was upbeat about overall growth prospects and did not see any serious

risks to the economy in the medium-term, including from a softening in oil prices. The economy is developing on two separate and independent tracks, with the non-extractive sectors demonstrating significant sustainability, again independent of the energy sector.

13. (C) Energy Reform. Dvorkovich conveyed a sense of steady confidence that reforms currently in play would bear fruit over the next 2-4 years. He said independent producer access to Gazprom's pipeline monopoly was still insufficient, but that the drive to close the 2010 gap in gas supplies was sharply changing that dynamic in favor of the independents. Talk of freeing prices for Gazprom's industrial users was serious, but success was not a foregone conclusion. Regardless, by 2010, the gas sector would have undergone "seminal change." On electricity reform, he complained that UES Chairman Chubays often strained the system with his

SIPDIS

maximalist approach to liberalization, but that the effect of his efforts had been to drive reform much faster than might have been expected.

14. (C) Tax Reform. For the past year, Dvorkovich has struggled against Finance Ministry objections to advance a plan to replace Russia's value added tax (VAT) with a sales tax. His position is gaining momentum, as many were coming to realize just how open to abuse the VAT system had become (despite the enthusiasm of the early 90's which held that a VAT approach was virtually corruption-proof). They had carefully studied the U.S. model of state sales tax and had drawn lessons, both positive and negative from our experience.

15. (C) Banking Reform. Dvorkovich, like many of his colleagues who have risen steadily through the system since the mid- 1990's, shared his dismay at the death of Central Bank Deputy Chairman Andrey Kozlov. He said the search was

MOSCOW 00011765 002 OF 003

on to find a suitable replacement, with number of candidates under consideration -- most prominently former Finance Minister Mikhail Zadornov (who Dvorkovich considered the best qualified of the group). Evidence was emerging to support the theory that Kozlov's work on cross borders bank transfers had triggered his assassination -- which made sense -- he doubted that Russian banks were still so heavily criminalized as to go after a senior official in this manner.

The banking sector overall is in the midst of an intense recapitalization, fueled by both domestic and foreign investment, and that this will bring significant competition to bear in the sector over the next few years to the benefit of the economy as a whole.

16. (C) The Law on Strategic Sectors. Dvorkovich himself has led the debate on the need to develop a CFIUS-like (i.e., Committee on Foreign Investment in the U.S.) approach in Russia, and he confirmed that the draft law is now in motion again, having been submitted last week to the Government. It will likely reach the Duma during the current session. Outstanding issues remain 1) the trigger threshold for government review of an investment in a strategic sector (the FSB is pressing for a 30% stake trigger, vs. the 50% stake advocated by the rest of the interagency) and 2) the size of oil and gas fields that would be automatically subject to review (on which opinions still differ widely).

17. (C) Production Sharing Agreements (PSAs). Economic Minister-Counselor raised USG concerns about contract sanctity and apparent efforts to reopen PSAs. Dvorkovich complained that the operators of Sakhalin II had abused the terms of their generous ("the most generous") PSA through inexplicable cost overruns. The overruns significantly reduced the overall profitability of the project, and caused a 2-3 year delay in the start of payments to the GOR. Echoing an October 17 conversation with Deputy Economic Minister Kiril Androssov, Dvorkovich said the government

expected the consortium to enter into good faith negotiations on the cost overrun issue, a process which was now underway. Dvorkovich confirmed the positive assessment we have heard from others in the GOR about ExxonMobil's Sakhalin I project, which is seen as delivering on-time and on-budget.

18. (C) WTO. Economic Minister-Counselor impressed upon Dvorkovich the seriousness of the emerging situation created by the Russian Veterinary Service (VPSS) in the context of our WTO negotiations. She complained that it simply flies in the face of common sense for the Vets to assert that U.S. meat exports were of substandard quality. Economic Minister-Counselor urged that the Russian side not allow itself to be caught up in VPSS hyperbole. Dvorkovich agreed to try and keep the discussion balanced. He also sought assurances that other open issues in the negotiations were progressing, and Economic Minister-Counselor suggested that it appeared so, given the concentrated efforts of both USTR and MEDT since July.

19. (C) IPR. Economic Minister-Counselor expressed deep concern about Part IV of the Civil Code on IPR. All indications were that a deeply-flawed text was moving towards precipitous passage in the Duma, all driven by some perceived Presidential imperative. Better to get it right than have to amend the text extensively after passage. Dvorkovich expressed a clear understanding of the issue, noting that the outcry against this legislation had been very vocal. He agreed to raise it with Deputy Prime Minister Dmitriy Medvedev, and would see if the Kremlin might be able to make clear to the Duma the need for accuracy over speed. Economic Minister-Counselor repeated USG willingness to engage on the text, noting our July and early October USTR-led delegations to Moscow.

110. (C) Boeing. In an aside, Dvorkovich commented that the Boeing sale of 22 787's to Aeroflot was explicitly tied to the outcome of our WTO negotiations. This was true even though depriving Aeroflot of the sale made little sense since

MOSCOW 00011765 003 OF 003

Airbus simply had no competing plane to sell. Economic Minister-Counselor drew his attention to the upcoming October 24 Aeroflot board meeting and asked if a way forward could be found to keep this sale from an unnecessary demise after November 1, after which Aeroflot might still be able to buy the planes, but not at the price or delivery date in the current package.

111. (C) Federal-Municipal Relations. Dvorkovich confirmed that a significant effort was underway to get Municipal reform on track. The basic idea calls for Municipal-level (County-equivalent) units of government to become fully operational by January 1, 2009. This entails the development of a property tax system, which is being coupled with an ever increasing devolution of responsibilities to town councils -- making them accountable to the populace for basic services and maintenance. Legislation refining those responsibilities is before the Duma even now. Unfortunately, Municipalities have been far from uniformly successful to date at the mechanics of establishing an independent revenue stream, which has necessitated suboptimal Federal transfers straight from the top to the bottom of the fiscal federalism ladder. In select instances, federal authorities are working these transfers through regional governments, but this was dependent on the quality of regional officials.

112. (C) Comment. Dvorkovich clearly understands our concerns about the meat safety, IPR protection, and the WTO negotiations, as well as PSA contract sanctity. Looking at the broad sweep of reform over the past two years, it was clear that in the wake of the fiasco surrounding the implementation of the monetization program in January 2005, reformist elements in the GOR had scaled back their ambitions. Yet this conversation suggests that reformers have been quietly advancing their agenda -- although not

under the reform banner. This is all the more interesting in light of Kozlov's murder and well-publicized actions that seem antithetical to the trend described here. Dvorkovich may be overly optimistic about the results, but progress is possible over the next year on tax and electricity reform, independent access to the gas pipeline monopoly, and perhaps even passage of the Strategic Sectors and Subsoil laws.

BURNS